VZCZCXRO9399
RR RUEHLH RUEHPW
DE RUEHIL #2576/01 2121255
ZNR UUUUU ZZH
R 301255Z JUL 08
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 8118
INFO RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEHBUL/AMEMBASSY KABUL 8943
RUEHNE/AMEMBASSY NEW DELHI 3587
RUEHLO/AMEMBASSY LONDON 8398
RUEHKP/AMCONSUL KARACHI 0106
RUEHLH/AMCONSUL LAHORE 5851
RUEHPW/AMCONSUL PESHAWAR 4633
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
RHMFISS/CDR USCENTCOM MACDILL AFB FL
RUEAIIA/CIA WASHDC
RUEKJCS/SECDEF WASHINGTON DC

UNCLAS SECTION 01 OF 03 ISLAMABAD 002576

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN PREL PK
SUBJECT: STATE BANK OF PAKISTAN RAISES KEY DISCOUNT RATE AS MULTIPLE PRESSURES WEIGH ON THE ECONOMY

¶1. (SBU) Summary: In an effort to curb rising inflation, the State Bank of Pakistan (SBP) raised its key discount rate by 100 basis points to 13 percent. SBP Governor Dr. Shamshad Akhtar defended the Bank's decision, citing increased risks to the economy from rising inflation and worsening current and fiscal account deficits. The GOP's current fiscal year deficit target already appears untenable, further complicating prospects for macroeconomic stability in the short term. Inflationary pressure continues to weigh on the economy; headline inflation reached a thirty year high of 21.5 percent in June 2008, coupled with a 32 percent rise in the cost of food. Pakistan's business community has been critical of recent monetary policy tightening, asserting that as the cost of production rises, exports will become less competitive. End Summary.

¶2. (SBU) Citing multiple risks to Pakistan's macroeconomic stability, including rising inflation and deteriorating fiscal and current account deficits, the State Bank of Pakistan (SBP) raised its key discount rate by 100 basis points to 13 percent. The July 29 decision is the fourth consecutive rate increase in the past year; the Bank's discount rate was 9.5 percent in July 2007. The move is seen as an attempt to contain aggregate demand, and consequently, inflationary pressure. In announcing the decision, SBP Governor Dr. Shamshad Akhtar opined that the Government of Pakistan (GOP) would need to reduce borrowing from the SBP and decrease the growth of imports, particularly fuel, in order to achieve the Bank's goal of reducing inflation (Note: GOP borrowing from the SBP reached an all-time high of Rs 689 billion (around USD 10.4 billion at the average exchange rate for the period) in the recently concluded 2007-08 fiscal year. End Note). The SBP Central Board of Directors also recommended that the GOP retire Rs 21 billion (USD 300 million) in debt owned to the SBP each quarter of the current fiscal year, aiming to reverse the adverse impact of record GOP borrowing from the State Bank.

BUDGET DEFICIT TARGET UNTENABLE?
- - - - - - - - - - - - - - - - -

¶3. (SBU) The GOP's fiscal year 2008-09 budget projects a budget deficit target of 4.7 percent of GDP (Note: Pakistan's fiscal year runs from July 31 to June 30. End Note). However, this target is based on the Finance Ministry's assumption that the FY07-08 deficit was 7 percent of GDP; the State Bank estimates that the figure is closer to 8.3 percent. The Bank has publicly stated that it believes the Federal Government is underestimating spending and overestimating revenue, making the 4.7 percent target untenable. While the GOP has announced that expenditure growth will be capped at 6.5 percent this fiscal year, government spending has risen an average of 20.3 percent per year over the past five years.

Similarly, the GOP estimates tax revenues will increase by 24 percent this fiscal year, despite growing at only 12.8 percent per year over the past five years.

¶4. (SBU) Despite multiple GOP pledges to reduce borrowing from the State Bank of Pakistan, including one such promise made by Finance Minister Naveed Qamar on July 22, the Government has already borrowed Rs 32.9 billion (USD 470 million) in the first 25 days of the current fiscal year. SBP officials caution that even a minor deviation from the GOP's budget deficit target would have a profound impact. The SBP estimates that a one percent increase above the target deficit of 4.7 percent would require Rs 100 billion (USD 1.43 billion) in additional borrowing from the State Bank.

AGGREGATE DEMAND AND INFLATION BOTH CONTINUE TO RISE
- -

¶5. (SBU) The difference between real domestic aggregate demand and the supply of goods and services widened in the recently concluded fiscal year. Increases in both the current account deficit and fiscal deficit are a manifestation of this widening gap. The SBP estimates that real domestic demand grew by 7.1 percent versus a 5.8 percent growth in real supply, mainly driven by increased public and private consumption expenditures. Real investment expenditures grew at a subdued 3.4 percent. The rise in consumption also reflected a drop in national savings, leading to a larger savings/investment gap. The State Bank continues to believe that the level of real GDP remains well above potential national output. In short, the total of goods and services being produced by Pakistan's economy exceeds what the country can sustain in the long run with stable inflation.

¶6. (SBU) Headline inflation reached a 30 year high of 21.5 percent year-on-year in June 2008 while food price inflation rose to a record 32 percent. Average consumer price inflation for fiscal year 2007-08 came in at 12 percent, well above a target of 6.5 percent. Average food price inflation rose 17.6 percent for the year with non-food price inflation rising 7.9 percent. A decrease in productive capacity, continued strong aggregate demand, and the multiplier effects of rising global fuel prices all contributed to rising domestic inflation.

MACROECONOMIC INDICATORS TREND DOWN
- - - - - - - - - - - - - - - - - -

¶7. (SBU) Domestic macroeconomic imbalances, in part due to the previous government's reluctance to reduce energy subsidies in the face of rising global fuel costs, continue to reduce the current government's options for dealing with Pakistan's economic woes. International liquidity concerns, decreasing global growth and the rising cost of commodities all impacted overall macroeconomic health. During its 2007 preparation for the FY 2007-08 budget, the GOP projected it would pay an average of USD 65 per barrel for imported oil. Pakistan actually ended up paying an average of USD 86 per barrel, causing the current account deficit to swell. (Note: Pakistan has a concessionary price deal for Arabian light crude from Saudi Arabia and other regional producers. End Note) In addition, the GOP had to swallow a USD 3.5 billion food import bill as domestic agricultural production slumped and global prices rose.

¶8. (SBU) Decreased portfolio investment and lackluster privatization receipts both contributed to a rise in the current account deficit, despite USD 5 billion foreign direct investment (FDI) in the fiscal year. Consequently, 30 percent of Pakistan's FY07-08 current account deficit was financed by a USD 4.3 billion drawdown of foreign exchange reserves, almost all of which occurred in the second half of the fiscal year. Pakistan's foreign exchange reserve import coverage fell from 31 weeks at the end of June 2007 to 17 weeks at the end June 2008. Reserve depletion, coupled with rising investor pessimism, has resulted in a sharp depreciation of the Pakistan rupee vis-`-vis the dollar.

REACTION FROM PAKISTANI BUSINESS LEADERS

- -

¶9. (SBU) Pakistan's business community has been critical of recent monetary policy tightening, asserting that as the cost of production rises, exports will become less competitive. Former Lahore Chamber of Commerce and Industry president Anjum Nisar remarked that the rate hike was unlikely to stop inflation but would increase the cost of borrowing and consequently, business operations. State Bank auditors reviewed financial data from several non-financial sector companies listed on the Karachi Stock Exchange. They found that, on average, financial expenses constituted only 2.4 percent of overall corporate costs, versus 4.7 percent in 2001. In 2007, average corporate costs grew by 12.1 percent while financial expenses grew by 0.7 percent only, refuting private sector claims.

COMMENT
- - - -

¶10. (SBU) Comment: The unsustainable fiscal deficit target does not bode well for Pakistan's future macroeconomic stability, its credit rating or its ability to attract significant new investment. Multiple internal and external funding constraints make the financing of an even larger fiscal deficit unlikely. Excessive borrowing from domestic sources, including the State Bank, may reduce credit available for the private sector, further hampering already low investment growth.

¶11. (SBU) Comment Continued: Pakistan's consumption-led growth of recent years has finally led to spiraling inflation. Expenditures and imports, particularly of fuel, must be contained now. By quickly and effectively addressing structural constraints in multiple sectors of the economy, Pakistan may be able to improve productivity, particularly in lagging industrial and agricultural sectors. Improving long-run factor productivity remains crucial to ensuring both price stability and long-term sustainable growth. However, in the short term, Pakistan's dwindling foreign currency

reserves are a real concern. Whereas Post contacts would laugh off the prospect of an emergency International Monetary Fund (IMF) program only months ago, the sentiment is starting to change. For some, it has become a question of when, not if, international financial institutions will have to come to the rescue. End Comment.

ARCHIBALD